NEGATIVELY AMORTIZING MORTGAGES

Introduction

A conventional fixed-rate mortgage holds the interest accrual rate and the payments constant over the life of the loan. A portion of each monthly payment reduces the outstanding principal of the loan. Negative amortization (NegAm) adjustable rate mortgages (ARMs) are structured such that the outstanding principal balance may increase, even though payments are current. Negative amortization occurs when the borrower makes a payment at an interest rate that is lower than the accrual rate; therefore, the monthly payment is insufficient to cover the interest expense, and the difference is added to the principal amount.

If lenders carefully underwrite NegAm loans with prudent loan to value (LTV) percentages and monitor the loans closely, the added credit risk may be small and manageable. However, aggressively underwritten NegAm loans without adequate controls raise supervisory concerns. In addition, the credit performance of NegAm loans is particularly vulnerable in an economic environment of rapidly rising interest rates and stagnant or falling property values.

NegAm Products/Features

Most NegAm loans have the following common features:

- Begin with an introductory teaser rate
- Borrower choice of payment amount
- A lagging aggregate interest rate index
- A cap on annual payment increases
- Contain maximum principal accrual limits
- Mandatory recast dates.

Teaser rate. Typically, a savings association originates a NegAm loan with a low introductory "teaser" rate. This may be more than 200 basis points below the fully indexed loan rate. This teaser rate is generally in effect for a period of one to three months. During the teaser rate period, the borrower's payment rate is the same as the lender's accrual rate (interest rate). At the expiration of the teaser rate period, the loan's interest rate immediately rises to the fully indexed rate; however, the minimum required loan payment remains the same until the next payment adjustment. During this period, the loan is typically negatively amortizing.

The lender determines the interest rate by adding a margin, stated in the mortgage, to the underlying index rate. This margin over the index varies with competitive pricing pressures, but is usually in the range of 200 to 300 basis points.

Payment amount. Borrowers typically have four payment options available with these loans:

- An amount sufficient to amortize the loan over 30 years.
- An amount sufficient to amortize the loan over 15 years.
- Interest only.
- A minimum payment that permits negative amortization.

Index. The NegAm loan's interest rate typically adjusts either every month, six months, once a year, every three years, or every five years. Historically, most NegAm interest rates were based on the 11th District Cost of Funds Index (COFI). However, in the last few years, lenders have shifted away from COFI and now use other indexes such as the 12-Month Treasury Average (MTA). Both COFI and MTA have a delayed response to interest rate changes compared with the constant maturity Treasury (CMT) index. This lagged response reduces the potential for borrower payment shock. It also, to the extent that an association's liabilities more closely resemble the COFI than the CMT, reduces that association's basis risk from an asset/liability management perspective. However, if the spread between an association's cost of funds and COFI widens for whatever reason, the association may face substantial income compression.

Payment caps. Payment increases or decreases on NegAm loans are typically capped at 7.50 percent per year. If the capped payment is not sufficient to fully amortize the loan, the shortfall is added to the loan balance. A shortfall occurs when the payment rate is less than the accrual rate.

Accrual limits and recast dates. NegAm loans typically recast at the earlier of: (1) every five years, or (2) when the loan balance increases to more than 110 percent (sometimes 125 percent) of the original loan amount, known as the principal accrual limit. When recast, the loan payment will adjust to a level to fully amortize the loan over the remaining 25 years and is not subject to the 7.50 percent annual payment cap. For a $200,000 loan with a 110 percent accrual limit, the recast would occur if the principal balance increased to $220,000. If the initial LTV were 80 percent, the LTV would have increased to 88 percent at the recast date (assuming no documented increase in property value). Other maximum principal accrual limits may also be encountered.

NegAm Risks

ARM lending involves a transfer of interest rate risk from the lender to the borrower. As a tradeoff, the lender must assume the additional credit risk associated with a borrower's potential inability to service the loan if interest rates rise. NegAm loan products were developed, in part, to help prevent payment default from occurring because of interest rate spikes. They have proven able to mitigate some of the risk associated with payment shock and prepayment.

Underwriting standards. Lenders do not directly hedge the option or credit risk associated with NegAm loans, but control the risks with appropriate underwriting standards, caps, and limits. The combination of deep teaser rates, aggressively qualifying borrowers at below fully indexed rates, high principal accrual limits, and the lack of initial LTV controls increase the credit risk to the lender.

Payment shock. NegAm borrowers may face recast payment shock, where the loan payment adjusts upward to fully amortize the principle balance over the remaining life of the loan without the protection of interest rate or payment caps. Borrowers may not be able to continue to make the higher payments. This is especially true where lenders make NegAm loans to subprime borrowers or there are inadequate underwriting controls. As a group, subprime borrowers are more likely to utilize the NegAm option, lessening future payment shock protection.

Capitalized interest. Lenders may record negative amortization as income in the form of capitalized interest. The lender does not actually receive the negative amortization amount as a payment from the borrower. Under generally accepted accounting principles (GAAP) the lender capitalizes (adds to the loan balance) the negative amortization interest amount and recognizes the amount as income as long as the capitalized interest is considered collectible. The collectibility of the interest depends on the borrower's ability and willingness to pay, which itself can be influenced by the size of the loan relative to the property value. An increasing capitalized interest balance may indicate increasing credit risk, as it might indicate declining borrower equity and less available payment shock protection for the portfolio. A high level of capitalized interest may also create cash flow or liquidity concerns for the lender.

Credit risk. LTVs can increase over time (if property values decline or the borrower chooses to make the minimum payment), which increases the credit risk to the association. However, recast requirements should prevent runaway LTVs. If property values do not appreciate and interest rates rise, all lenders may be adversely affected, but NegAm lenders more so because of escalating LTVs. Additionally, the reported earnings sometimes mask credit risk in a NegAm portfolio, where the association is accruing income at a higher rate than the borrower is paying on the loan. Traditional credit quality monitoring reports of point-in-time delinquency and default data may lag as indicators of asset quality problems because borrowers facing payment problems can opt to reduce their monthly payments without causing the loan to go delinquent or disrupting the income accrual on the loan.

NegAm Compliance Requirements

Promotion of NegAm loans must comply with OTS and other federal regulatory requirements. Section 563.27 prohibits a savings association from advertising or misrepresenting its services, including the benefits, costs, terms, or conditions of NegAm loans originated. NegAm loans may not be marketed or extended in a manner that causes the lender to discriminate against borrowers on a basis prohibited by the fair lending laws such as the Fair Housing Act, the Equal Credit Opportunity Act, Regulation B or OTS Nondiscrimination regulations. The Truth in Lending Act (TILA), as implemented by Regulation Z and its staff commentary, imposes certain requirements with respect to NegAm loans dealing with the disclosure of teaser rates, ARM loan features, negative amortization conditions, and balloon payments. In addition, certain high-cost mortgages defined by the Home Ownership and Equity Protection Act provisions of TILA are prohibited from having negative amortization features. Moreover, NegAm loans are subject to evaluation under the Community Reinvestment Act and implementing regulation as part of the association's performance in meeting the credit needs of its community.

NegAm Risk Management

Not all NegAm loan portfolios are structured the same or have higher credit risk. If lenders carefully underwrite NegAm loans with prudent LTVs and monitor the loans closely, the added credit risk they face may be small and manageable. However, aggressively underwritten NegAm loans without adequate controls raise supervisory concerns.

Lenders engaged in a NegAm lending program should monitor the quality of the NegAm portfolios closely. Specifically, lenders should track and monitor all loans with the NegAm option and quantify the borrowers' preferences regarding NegAm loan payments. The choice of making the fully amortizing versus the minimum payment is a borrower option, the exercise of which is a revealing indicator of a borrower's ability to service the loan. Additionally, lenders should:

- **Use appropriate underwriting standards**. Underwriting standards for NegAm loans should meet the real estate lending standards set forth in 12 CFR §560.101. Poor underwriting can create loans where the potential risk from negative amortization is excessive.

- **Identify the percentage of borrowers utilizing negative amortization and the associated capitalized interest**. Because capitalized interest may have accumulated over several years, lenders should report balances by loan vintage. If capitalized interest is substantial, its impact on the association's income levels should be analyzed to evaluate the quality of earnings. Excess capitalized interest may also create possible cash flow or liquidity concerns.

- **Track NegAm loan performance by program and origination year**. Point-in-time delinquency reports for NegAm loans can be misleading and mask immediate problems not reflected in delinquency rates. NegAm delinquency rates are generally only meaningful when combined with an analysis of borrower utilization and capitalized interest levels. If NegAm utilization and capitalized interest levels are increasing, future credit problems may arise.

- **Track performance by credit scores**. If warranted, segment the portfolio into different credit score groups to better track performance and risk exposure.

- **Monitor the impact of its use of NegAm loans on its record of meeting the credit needs of its community, including low- and moderate-income markets**. While many NegAm loan programs offer expanded credit opportunities to communities, a few may have the effect of unduly eroding borrowers' equity and thus adversely affecting the communities.

Qualifying for the 50 Percent Risk-Based Capital Treatment

OTS regulation 12 CFR § 567.6 establishes a 50 percent risk weighting for qualifying mortgage loans. Section 567.1 defines qualifying mortgage loans as one- to four-family residential first mortgage loans that are performing, are prudently underwritten, and have LTV ratios at origination of 90 percent or less, or are covered by private mortgage insurance. To qualify for a 50 percent risk weighting, NegAm loans should meet the above requirements. Should a portfolio of NegAm mortgages present safety and soundness concerns, OTS may direct the association to risk weight some or all of the NegAm mortgages and any future production at 100 percent or more.

Examination of NegAm Lenders

You should carefully analyze NegAm lending programs and determine if the association has appropriate underwriting controls and standards as described throughout this Appendix. As with all loan types, you will evaluate the level of credit risk in the association's portfolio and ensure that loan loss reserves and capital are sufficient to support the level of risk.